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UNCLAS SECTION 01 OF 03 MEXICO 002709

C O R R E C T E D  C O P Y  (TEXT IN PARAS 3 AND 4)

SENSITIVE
SIPDIS

STATE FOR WHA/MEX, WHA/EPSC, EEB
NSC FOR RESTREPO, FROMAN
USDOC FOR 4320/ITA/MAC/WH/ONAFTA/GWORD
TREASURY FOR NANCY LEE, IA
ENERGY FOR WARD, LOCKWOOD AND DAVIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD ENRG ELTN EAIR PGOV SENV MX
SUBJECT: GOM PROPOSES 2010 ECONOMIC PLAN

REF: A. MEXICO 2639
¶B. MEXICO 2537

MEXICO 00002709 001.2 OF 003

¶1. (SBU) SUMMARY. On September 8, the GOM submitted its 2010 budget and fiscal reform proposals to Congress following weeks of market speculation about what the GOM would propose. The speculation follows looming risk of Mexico's possible credit downgrade. Plunging revenues (due to falling oil production/prices and economic recession), and public expenditure that grew in tandem with skyrocketing oil revenues from 2002-08, have caused a fiscal gap. To close the gap, the GOM sent Congress tough revenue and spending proposals aimed first and foremost at stabilizing the economy and preventing a credit-rating downgrade. While many analysts agree that the GOM has delivered a credible budget that responsibly attempts to address Mexico's fiscal limitations, the challenge remains pushing the ambitious package through a new opposition-dominated Congress. The 2010 economic package represents a new challenge to Calderon's negotiating skills and resolve. (See reftels.) END SUMMARY.

2.(U) Below please find the key figures and projections for the budget. The underlying assumptions use consensus numbers.

## Macroeconomic Assumptions

3.(U) Table 1: Underlying Assumptions and Macroeconomic Projections

| | 2009 | 2010 |
|---|---|---|
| Real GDP growth | -6.8 | 3.0 |
| Inflation (yoy) | 4.3 | 3.3 |
| Nominal Exchange Rate | 13.6 | 13.8 |
| Real Interest Rate | 1.2 | 1.2 |
| Current Acct (% of GDP) | -1.6 | -1.8 |
| US GDP growth | -2.6 | 2.3 |
| Oil Price (US$/barrel) | 51.0 | 53.9 |
| Avg Oil Exports (mb/d) | 1.23 | 1.11 |
| Oil Production (mb/d) | 2.62 | 2.50 |

## The Proposed Budget

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¶4. (U) Table 2: Public Finance 2009-2010 (% of GDP)

| | 2009 | 2010 | Real Gwth |
|---|---|---|---|
| Total Revenues | 22.4 | 22.1 | 1.4 |
| o/w tax rev. | 9.3 | 10.8 | 19.6 |
| o/w oil-related rev. | 6.6 | 6.9 | 7.0 |
| Total Expenditures (Incl. Interest) | 24.6 | 24.6 | 3.2 |
| Public Sector - Financing Costs | 2.4 | 2.4 | -0.7 |
| Primary Balance | 0.3 | -0.2 | |
| Overall Balance | -2.1 | -2.5 | 22.8 |

The Public Sector Deficit
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5.(U) For the first time since the passage of the 2006 Fiscal Responsibility Law (which incorporates a balanced budget rule), the GOM will invoke the exception clause that allows it to propose a deficit &under exceptional circumstances.8 The 2010 targeted overall balance is -2.5% of GDP (including Pemex infrastructure investment (-2.0%)) verses -1.8%, all of which is Pemex capital expenditure, in ¶2009. The targeted 2010 Public Sector Borrowing Requirement (PSBR), which is the budget deficit plus the balances of

MEXICO 00002709 002.2 OF 003

off-budget entities and programs, is 3.1% of GDP.

¶6. (U) The GOM projects a budget shortfall in 2010 of MX$374bn (3% of GDP), of which MX$219bn stems from a permanent decline related to the drop in oil proceeds and MX$155bn from a cyclical fall in revenue. To absorb the former, the GOM has proposed a combination of tax increases and expenditure cuts. To absorb the later, the GOM will draw MX$95bn from its oil stabilization funds and other non-recurring revenues and royalties, leaving a fiscal deficit of MX$60bn (0.5% of GDP) to be financed largely from external sources. The GOM projects the budget to be in deficit in 2011 (MX$40bn) and eventually in balance by 2012.

Total Revenue
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7.(U) Total revenue will rise (1.4%) in real terms in 2010, but will fall slightly (0.3) as a percent of GDP. The decrease will come mainly from lower non-oil, non-tax revenue. Oil-related revenues are projected to increase in real terms (7.0%) and as a percentage of GDP (0.3%) from their 2009 level. Tax revenue is expected to increase 19.6% in real terms and as a percent of GDP (1.5 percentage points). These projections incorporate the GOM's proposed tax reform and improvements in tax administration. The fiscal reform proposal includes:

--A 2% sales tax on all products (i.e. a VAT), of which 36% is for an anti-poverty program called &Oportunidades.8
--A 4% tax on telecommunications, except rural telephones.
--An increase in income tax from 28% to 30% at the top bracket and similarly at lower brackets from 4 minimum wages upwards ($494 per month).
--An increase in special taxes on beer, alcohol and tobacco.
--An increase in the tax on cash bank deposits from 2% to 3% reducing the eligible deposit from MX$25,000 to MX$15,000 in a month.
--The freezing of energy prices will be terminated, which will be reflected in a steady monthly increase; in gasoline, the price would jump by 17.1% in 2010. (Note: A similar increase was responsible for the pick-up in inflation in

¶2008. End Note.)
--The suspension of credit allowances just authorized last May between IETU (a minimum flat tax on businesses passed in the 2006 fiscal reform) and the income tax. (See septel for a more detailed summary/analysis of the proposed tax reforms.)

8.(U) Even though the expected oil and non-oil revenues for 2010 are higher than those observed for 2009, they will still be below those used for the 2009 budget. This is due to lower transitory non-oil revenues as economic activity will be under its potential level, and lower oil revenues as result of lower prices and the continuing downward trend in oil production.

Total Expenditures
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9.(U) Total expenditure will increase in real terms (3.2%) but remain unchanged as a percentage of GDP. At the same time, programmable expenditures will decrease as a percent of GDP from 18.8 to 18.5%. The proposal contemplates public spending reductions of MX$218 billion pesos (1.7% of GDP). Current federal government spending cuts envisaged include a freeze in salaries and new positions and reductions in services such as communications and travel. (Note: Reductions in administrative outlays and government downsizing do not require congressional approval. End Note.) The most politically spectacular, though relatively minor in terms of money saved, will be the elimination of three ministries:
-- Tourism will be merged into the Economy Secretariat.
-- Agrarian Reform absorbed into the Agriculture and Social Development Secretariats.
-- The Public Function Secretariat reduced to federal comptroller and absorbed into the presidential office.

10.(U) Spending policy will shift towards a greater focus on



social development programs. To justify the name of the 2% tax as a contribution against poverty, the GOM proposed a 50% increase in subsidies to poor households through the program &Oportunidades8 and an additional 20% increase in the program People's Insurance, which is a limited medical coverage with subsidized premiums.

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Market Impressions
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11.(SBU) The 2010 budget and economic guidelines have had a mixed reception. Although the macroeconomic projections are inline with the market consensus, there are concerns that the GOM's 3% GDP growth target may be optimistic given the possible recessionary impact of the fiscal austerity measures proposed. Moreover, the 3.3% year-end inflation target may be unachievable given the increase in energy and gasoline prices proposed. Analysts also note potential external and internal shocks to the economy (i.e. delayed recovery of the U.S. economy, resurgence of the H1N1 pandemic) that should be considered. There is also widespread doubt that many of the fiscal reform measures will pass (see reftels). While some economists we spoke to (who had been briefed by Carstens and his team) praised the fiscal reform measures and efforts to plug the deficit, many voiced concerns that the budget package lacked a long-term vision of how Mexico could improve its competitiveness and arrive at growth rates in the next decade of over five percent.

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Next Steps
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12.(U) Congress will consider the GOM's budget submission in

two phases, evaluating the GOM's revenue proposal first, followed by the expenditure proposal. In the second half of September, the main economic commissions in the lower house (budget and finance commissions) will be formed. The revenue proposal must be approved by the lower house by October 20 and by the Senate October 31. The expenditure proposal must be approved only by the lower house by November 15.

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Comment
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13.(SBU) Calderon has outlined an ambitious program for his remaining three years in office. Clearly, fiscal stability weighs heavier than reforms in this budget, but the GOM sees a stable economy as the means by which future reforms can be achieved. Past reform attempts have generally been watered down. The 2010 economic package will be the first test of Calderon's negotiating skills in an opposition-dominated Congress. Although some observers believe the economic package was pre-negotiated between the GOM and the leadership of the PRI, many perceive the rank and file of the PRI as reluctant to pass significant tax increases or subsidy reductions. On September 10, the PRI issued a statement that it would oppose a new 2% sales tax, applicable to all goods and services -- including many that are currently exempt from VAT (foodstuffs, medicines and health services). While the GOM proposes that revenue from the new tax be used to reduce poverty, the PRI argues that it would undermine the spending power of those on low incomes, and particularly objects to taxation of food and medicines. The party's lower house leader, Francisco Rojas, has proposed creating a congressional committee to examine companies' entitlement to tax exemptions -- the PRI has criticized budget proposals for not addressing such structural issues in the tax system.
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